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In The
SUPREME COURT OF THE UNITED STATES

October Term, 1962

No. 443

RUFUS F. AND MARGUERITE H. TURNER,
Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT AND APPENDIX

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To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States.

OPINIONS BELOW

The Memorandum Findings of Facts and opinion of the Tax Court is printed at pages 1 to 26 inclusive of the appendix, *infra*. And unofficially reported at P-H T.C. Memo. 1961—¶ 61, 101.

The opinion of the Court of Appeals, affirming the judgment of the Tax Court (in part) is dated May 16, 1962, and is printed at pages 26 to 33 *infra*, and reported in 9 AFTR 2d 1958 and ..... Fed. (2) .....

JURISDICTION

Rufus F. Turner, et ux,[1] by their attorneys, respectfully pray that a writ of certiorari issue to the judgment of the United States Court of Appeals for the Fourth Circuit, entered May 16, 1962, affirming (as to the issue below) the judgment of the Tax Court of the United States entered April 7, 1961. By order dated June 22, 1962, petitioner's motion for rehearing was denied. The jurisdiction of this Court is invoked under 28 U.S.C. §1254 and 26 U.S.C. §7482 (a) (IRC 1954).

STATUTES, REGULATIONS, AND RULINGS

Internal Revenue Code

"Section 351:[3] TRANSFER TO CORPORATION CONTROLLED BY TRANSFERROR

"(a) General Rule. —

"No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities ***.

"(b) Receipt of property. —

[1] Petitioner's wife, Marguerite H. Turner, is also a party to these proceedings because of a joint return filed in the tax year in question.

[3] Verbatim at App. 13-14 *infra*.

"If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

"(1) gain (if any) to such recipient shall be recognized, but not in excess of—

* * * * *

"(B) the fair market value of such other property received;

Regulations:

§1.351-2 *Receipt of Property.* (a) If an exchange would be within the provisions of section 351 (a), if it were not for the fact that the property received in exchange consists not only of property permitted by such subsection to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. No loss to the recipient shall be recognized.

Revenue Ruling 60-301; I.R.B. 1960—38, 7:

"It is, therefore, the position of the service that *personal characteristics or qualifications do not constitute goodwill as an item of property and do not exist in such form that they can be the subject of transfer.* Consequently, if a business is dependent solely upon the personal characteristics and competence of the owner, no element of goodwill exists with respect thereto and no portion of the sale price of the

business may be treated as proceeds from the sale of goodwill, irrespective of whether or not such sale comprehends a valid assignment of the right to the exclusive use of the firm name." (emphasis supplied)

QUESTIONS PRESENTED

1. Did the petitioner realize a taxable gain for the year 1957 upon the incorporation of his sole proprietorship under the provisions of §351, IRC 1954, and

2. If so, how much taxable gain resulted therefrom?

STATEMENT OF THE CASE

For a number of years prior to 1957, the petitioner had been successfully engaged in a wholesale fresh produce business at Martinsville, Virginia. On February 25, 1957, the petitioner incorporated (under the name of Cash Produce Company) the net tangible and intangible assets of his proprietorship on the following basis:

Assets:		
Net tangible	$49,363.36	
Intangible		
Good will	74,300.00	
Incorporation expense	230.10	
Total		$129,095.63
Liabilities & Capital		
Noncurrent Liability		
Note payable to officer—unsecured and without interest		48,893.46
Capital stock		75,000.00
		129,095.63

A financial statement for Cash Produce (reflecting the above) as of January 1, 1957, was prepared by the petitioner's accountant and on January 19, 1957, was transmitted to the Produce Reporter Company, Wheaton, Illinois, which publishes a credit rating reference book of produce firms. The petitioner received a reply from the Produce Reporter Company suggesting a subordination of the note to officer to trade creditors stating: *inter alia*:

> "The item of 'good will' is very correctly listed as an 'intangible asset', it is the type asset which is eliminated from credit consideration in arriving at Blue Book financial ratings."
>
> When your good will and incorporation expenses of $74,530.10 are eliminated from your statement, that January 1, 1957 corporation financial statement then shows a net worth of less than $500.00. (App. 5)

In response to this letter the petitioner on February 23, 1957 wrote to the Produce Reporter, as follows:

> "As principal stockholder, president and manager of Cash Produce Co., Inc. the undersigned will continue to honor credit extension with the same integrity and ability as in the past, and to personally guarantee payment of the corporations' debts in the same manner as prior to incorporation.
>
> "Though you suggest in your letter that a subordination agreement as to the corporation's debt to me is 'loaded' with possibilities of misunderstanding, you may accept this letter over my signature below as such an agreement, to the effect that any trade obligations

will most certainly be paid before any liquidation of this debt. Any drawings I made from the corporation above the minimal salary allowance provided for me will be charged against my annual profit-sharing. Furthermore, your letter ignored the fact that the note payable to officer of $48,893.46 was created by the charge of goodwill, and that the goodwill was a capitalization at 10% of the average net profits of the past five years. ***

"Nevertheless, to eliminate goodwill from credit consideration as you state should also require elimination of the debt which it created, leaving a remaining net worth of $49,363.36. To the latter should be added, if not more, by the subordination described above the value of the business real estate which I retained in my own right in the amount of $47,476.89, giving a total net worth for credit purposes (Excluding other personal assets) in the amount of $96,840.25, exclusive of good will."

At some time between February and November, 1957, the petitioner's accountant prepared for the petitioner an instrument as evidence of the obligation to the petitioner, which read as follows:

Notice of Indebtedness January 1, 1957

"For value received, we, Cash Produce Co., Inc., do hereby promise to pay to Mr. Rufus F. Turner, his heirs or assigns, the amount of Forty-eight thousand, eight hundred, ninety-three dollars and forty-six cents ($48,893.46) without interest, payable at the office of the corporation on or after February 1, 1958; also the corporation is not to furnish security of type for

this indebtedness. It is also agreed that the payee may draw funds from the corporation at any time upon the pledge of this note as security, said drawings to be deducted from the amount of this liability prior to settlement. "Accepted and agreed to the above this date January 1, 1957.

"/s/ Rufus F. Turner

Cash Produce Co., Inc.
/s/ Rufus F. Turner
Registered Agent
President."

On January 14, 1958, a debenture bond of $48,893.40 was issued by the corporation payable to the petitioner. Although, this bond was executed and filed with the Virginia State Corporation Commission on January 14, 1958, it was dated January 1, 1957. It was conceded by the Commissioner that this bond would constitute a security within the meaning of Section 351 (a) (App. 28).

This instrument was not adopted or ratified by any formal resolution of the stockholders or the board of directors of Cash Produce Company. (App. 8).

The petitioner testified that the indenture issued on January 14, 1958 was the final step of the plan to incorporate his business and that it was an integral part of the plan from its beginning; that its issuance was delayed by his accountant and his attorney while they were searching for the proper form. The testimony of both the attorney and the accountant supported the petitioner in this respect. The attorney testified that when the petitioner and his accountant were in his office in November of 1956 the petitioner

was primarily concerned with problems of his health and how he could obtain funds from his business after his retirement. The accountant confirmed this and stated that he had proposed an indebtedness from the corporation and that he had expressly warned the parties that the proposed indebtedness must be reflected in a longterm debenture incorporation and also satisfy the petitioner's desire for a source of funds after he reached sixty-five. The petitioner contended that the "notice of indebtedness" was merely a bond in order to avoid tax consequences at the time of temporary memorandum of debt and without legal (or tax) significance. (App. 30).

The Court of Appeals held that the Commissioner's and the Tax Court's determination that the "Notice of Indebtedness" was an *effective debt instrument* constituting "other property" *received* and taxable as "boot", within the meaning of Section 351(b) was not clearly in error. (App. 30) (Emphasis supplied)

The Court of Appeals further held that even accepting the testimony of the parties (which was rejected by the Tax Court) "the decision of the Tax Court was not wholly incompatible with their testimony". In this respect in its opinion the Court of Appeals stated (App. 30-31):

> "It is conceivable that at the planned meeting in November and December of 1956 these gentlemen decided that the corporate indebtedness to Turner should be reflected in a tax free long term debenture bond within the provisions of Section 351 (b), but as time went on and the bond was not forthcoming Mr. Turner grew impatient and especially when he learned that Mr. Ford was severing his connections with the ac-

counting firm which was handling his business. Mr. Turner insisted upon some evidence of the indebtedness which he could hold in his hands. (At this point it was Turner's intentions and conduct which became legally effective rather than that of his professional advisers.) Thus the issuance of the "Notice of Indebtedness" was not a step in an integrated plan conceived from the beginning but a change in plan which upset the original calculations of his professional advisers with unfortunate tax consequences to Mr. Turner."

The respondent has conceded that the good will attributable to petitioners sole proprietorship was purely personal to the petitioner. The nature of petitioners produce business is that of buying varied items of produce from distant suppliers (who would extend credit only on the basis of credit ratings provided by the Produce Reporter Company) and selling produce to local independent groceries on a competitive basis. . . . Upon incorporation, the petitioner entered into neither a non-competition or employment agreement with his new company. In fact, he was at that time in a state of declining health and is presently disabled and retired from his Company. Upon incorporation, the amount of good will was computed by his accountant on the basis of a capitalization of past earnings of the proprietorship without consideration of the fact that (a) the sole proprietorship warehouse valued at $47,476.89 was not transferred and (b) a constructive salary for the principal officer.

The Secretary of the Produce Reporter Company who is qualified as an expert in matters pertaining to the Pro-

duce industry testified that Produce businesses are seldom transferred as a unit and then only at less than "full asset" value and traditionally they have no going concern value and when they go out of business they are not usually sold as a unit but rather the individual trucks and refrigeration units, etc. are simply sold to different purchasers and that in the occasional instances when they are sold "it would not be at full asset value".

On the basis of the foregoing facts the Commissioner issued a "notice of deficiency" to the petitioner (pursuant to 26 U.S.C. §6212) determining that petitioner had realized a taxable capital gain ("boot") to the extent of the face value of the Notice of Indebtedness ($48,893.40). The petitioner timely filed a petition to the Tax Court of the United States for a redetermination of the deficiency under the provisions of 26 U.S.C. §6213.

ARGUMENT

A. *The Tax Court erred in failing to determine that the debt created upon incorporation of petitioner's sole proprietorship reflected for tax purposes "equity investment" and not a "true debt".*

The question here of whether the notice of indebtedness reflects true debt or an equity investment determines the taxability of the incorporation. For if the debt, in fact, represents a capital contribution, then the value of the debt is added to the cost of the petitioner's stock resulting in no "other property" existing, thus qualifying the transaction as a tax free exchange under the provisions of Sec-

tion 351 (a), IRC 1954 (or §112 (b) (5), IRC 1939.)[4]

The Tax Court recognized this argument but has rejected it on the following grounds (App. 24):

> "It is unnecessary to discuss petitioner's final contention, that the notice of indebtedness represented an equity interest equivalent to stock, in view of our holding that the notice of indebtedness is a note".

Nothing is contained in the opinion of the Court of Appeals to indicate whether it ever considered this argument despite the overwhelming authority contrary to the Tax Court's determination which was extensively presented and argued in the briefs and motions filed by the petitioner. (See Motion for Rehearing, Transcript of Record, Page 35).

Although the argument that a legally enforceable debt is in substance an equity investment is 999 times out of a 1000 made by the Commissioner, when he seeks grounds to deny deductions for interest, bad debts or capital losses, there is nothing that precludes the petitioner from raising it in his own behalf or precludes the use of the same criteria used in other cases for determining the question of "debt v. equity". *J. A. Maurer, Inc.* (1958) 30 T. C. 1273, 1929.

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[4] In *Gooding Amusement Co. v. Comm.*, 236 F. 2d 159, 165, the Court stated:

> "Since we have found hereinabove that the notes were received by petitioners and which by them are claimed to represent '* * * other property' * * * under section 112 (c) (1), were in fact representative of risk capital invested in the nature of stock, the '* * * solely in exchange for stocks or securities * * *' requirement of section 112 (b) (5) was, in our considered judgment, satisfied".

nor is the petitioner in any way estopped to argue that "substance" governs "form" however inconsistent his actions prior thereto. (*Comm.* v. *R. J. Reynolds Tobacco Co.*, 260 F.2d 9 (C.A. 4th, 1958).

Whatever may have been the reasons for the failure of the Court of Appeals and the Tax Court to answer the argument here presented, it is certainly the duty of lower courts "to distinguish with clarity" what they hold as a conclusion of law. The effect of the decision of the Court of Appeals is to uphold the Tax Court's determination that the notice of indebtedness does not represent an equity investment because it is a "note".

The fact that the obligation is reflected in the form of note or is in fact a legally enforceable debt has been held in an almost limitless number of cases to be only one of many circumstances that are to be considered in determining whether the debt represents an equity interest. The Tax Court's holding is in conflict with the Supreme Court's decision in *John Kelley Company & Talbot Mills* v. *Commissioner*, 326 U.S. 521, 66 S.Ct. 299, 304, wherein it is stated:

> "*** There is no one characteristic, *** which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts. So called stock certificates may be authorized by corporations which are really debts and promises to pay may be executed which have incidents of stock. ***"

The Fourth Circuit's failure to remand this case to the Tax Court would appear to be in conflict with the holding

in *Gilbert* v. *Commissioner*, 248 F.2d 399 (C.A. 2d), where that court remanded the case to the Tax Court stating:

> "*** we are unable fully to understand the basis for the Tax Court's holding that 'the advances made by Benjamin were in reality contribuions of risk capital and did not give rise to bonafide debts on the part of the corporation" and *"The opinion of the Tax Court only states a conclusion without assigning the reason therefor."* This makes it impossible for us to determine whether appropriate standards have been employed in reaching that conclusion." (Emphasis supplied)

Whatever may be the merits for a remand the petitioner here prefers a reversal for the reason that the undisputed facts here fulfill every *single* criteria presently being used by a number of different Courts of Appeal to determine whether debt, in fact, represents equity (or risk) investment.

The notice of indebtedness had substantially the same face value ($48,893.46) as the net value of the tangible assets ($49,363.36) transferred upon incorporation. The notice of indebtedness had no fixed maturity date, it was non-interest bearing, unsecured, intended to be subordinated to the debts of trade creditors, had no value as collateral and as stated by the petitioner in his letter to the Produce Reporter Company (written prior to the date of the transfer of assets to the company) it was intended to be paid only out of the profits of the company. Since the petitioner was the sole stockholder at the time of incorporation there was an identity of interest beween the creditor and the stockholder of and the company could not have obtained

such a loan from an outside lending institution. The tangible assets were intended to be a permanent investment at the risk of the business. The name given to the certificate evidencing the indebtedness was "notice".

In the 16 years since the Supreme Court has considered the question of debt v. equity in *John Kelley and Co., supra,* there have been an uncountable number of cases litigated and articles written on this most contested question in the tax field.[5] In practically all of these cases the Commissioner was successful in arguing that the "debt" was "equity investment".

In the course of this continuous litigation some of the Courts of Appeal have evolved a series of criteria (each factor or standard being derived from some important prior case) with which to test the facts of each case to determine whether *on balance* a debt or equity exists. What seems to be the most comprehensive set of criteria and most widely cited is contained in the case of *O. H. Kruse Grain & Milling Company* vs. *Commissioner*, 279 F.2d 123, 125-126, (C.A. 9th, 1960), wherein it is stated:

> "There are at least eleven separate determining factors generally used by the courts in determining whether amounts advanced to a corporation constitute equity capital or indebtedness. They are (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce

[5] A large collection of such cases and incisive analysis may be found in 4 Mertens Law of Federal Income Taxation §§ 26.10c-26.12.

> the payment of principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) 'thin' or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of 'dividend' money; (11) the abiliy of the corporation to obtain loans from outside lending institutions."

In *Brake & Electric Sales Corp.* v. *U. S.*, 287 F.2d (C.A. 1, 1961) upon the incorporation of a sole proprietorship, a five year note for $90,000.00 with 4% interest payable thereon was received representing the value of the net tangible assets transferred and was held by the court to represent "equity" investment. $20,000.00 in stock was issued and good will in excess of $20,000.00 was transferred. The Commissioner did not there assert that the note received was taxable as "boot", he merely sought to disallow the interest paid on the note on the grounds that the notes represented an equity investment in the corporation subject to the risks of the corporate venture. In affirming the decision of the District Court, the Court of Appeals, *supra*, stated:

> "In reaching this conclusion the district court looked to the substance of the transaction. See Gilbert v. C.I.R., 262 F.2d 512 (3 AFTR 2d 456) (2 Cir.), cert. denied 359 U.S. 1002 (1959). It noted that one of the factors frequently occurring in cases involving this type of issue, disproportionate debt-equity ratio, was not present in the instant case. In the court's view, however, there were other facors which indicated the capital investment nature of the transaction.

"The district court mentioned six factors present in the instant case in weighing the situation to determine the realities of the transaction. The six mentioned are: (1) that the assets transferred to the corporation as part of he transaction were assets essential to the conduct of the business; (2) that Brown was at all times in control of the situation respecting the business and the decision of enforcing the notes; (3) the notes were regularly extended when they fell due; (4) Brown's testimony that he would never have demanded payment if the corporation would be required by such demand to raise the cash by borrowing from another source; (5) that under the realties of the situation in 1950 Brown could not realistically have expected that in five years the plaintiff would be able to pay $90,000 in cash at least without putting itself into a disadvantageous financial position, a circumstance which Brown as sole stockholder would certainly want to avoid; * * *"

The holding of the Tax Court as affirmed by the Court of Appeals on this question is contrary to the decision in *P.M. Finance Corp.* v. *Comm.*, 9 AFTR 2d 1454 ..... F.2d ..... (C.A. 3 May 10, 1962) and cases collected therein. In determining that "the money advanced by the Franks in substance was placed at the disposal of the business on a permanent basis. It seems to us that this money constituted risk capital, as it did to the Tax Court", the Court, above, relied principally upon precedent which holds that in the case of closely held corporations, taxpayers must present persuasive evidence that the debt in form is not in reality equity.

Although the petitioners believe that a conflict in the Court of Appeals is a good and sufficient reason to grant Certiorari, there is another far more compelling reason. The *John Kelley Co. case* laid down the rule that "no one characteristic" was decisive of the debt vs. equity question but the *Kelley Co.* case was decided under the "Dobson Rule" and for that reason its value as a precedent has been questioned[6] since the Revenue Act of 1948 amended 26 USCA §1141 (a) to permit the Court of Appeals to review the Tax Court's findings of fact. In the Dobson case[7] the Supreme Court lamented the ever increasing litigation in the Tax Court and sought a cure for it. However, the experience of 16 years since the *John Kelley Co.* case has shown that the *Kelley* case has not been very effective in curtailing any litigation on this question. In fact, its effect has been just the opposite and this is understandable for it set no standards and adopted no criteria (which only the passage of time can provide) to determine whether debt or equity existed. Therefore, we believe that the time is truly ripe for the Supreme Court to re-examine the entire debt vs. equity question and to put its stamp of approval on the criteria set forth in the *Kruse* case, *supra*, and other pertinent criteria established in other important Court of Appeals decisions, thus bringing to an end an era of seemingly endless conflict.

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[6] *Gilbert* v. *Comm. Supra.*

[7] *Dobson* v. *Commissioner*, 1943, 320 U.S. 489, 64 S.Ct. 239, 88 L.Ed. 248.

B. *The notice of indebtedness was a transitory and legally ineffective instrument and should not be treated as the concluding step in the incorporation of petitioner's business.*

The opinion of the Court of Appeals (App. 32) that the notice of indebtedness, although not a legally authorized[8] or effective debt instrument may be a concluding step (despite all testimony to the contrary) in the incorporation of petitioner's business for reason of the presumption that a principal stockholder would not impose a legal defense to its payment, is directly contrary to the test in "step-transaction" cases adopted here by the Tax Court and approved by the Court of Appeals in the case of *ACF-Brill Motors Co.*, 14 T.C. 263 (1950), aff'd. 189 F.2d (C.A. 3rd) 764, cert. den. 342 U.S. 886 (1951), which provides:

> "The test is, were the steps taken so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."

The petitioner's demand for and receipt of a legally ineffective temporary memorandum of debt gave him no additional rights he did not, as principal stockholder, already possess. The minutes of the Company contemplated that he would receive a *legally effective note* and not a *legally ineffective notice* (with drawing account features added thereto). A legally effective instrument was subsequently received by the petitioner on January 14, 1958,

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[8] It is well settled in Virginia and elsewhere that an officer cannot legally bind his company in a contract with himself without "authority" expressly given. 13 Am. Jur. §932; 4 Michie's Jurisprudence (Va., W.Va.) Corporations § 164.

which the respondent has conceded is a security (and which petitioner admits is the equivalent of stock).

The decision here appears to be contrary to the opinion of the Supreme Court that intermediate steps which are intended to be merely transitory may be disregarded. *Groman* v. *Commissioner*, 302 U.S. 82, 954, 58 S.Ct. 108, 82 L.Ed. 63; *Helvering* v. *Bashford*, 302 U.S. 454, 58 S.Ct. 307, 82 L.Ed. 367. In *Bulil* v. *Kavanaugh*, 118 F.2d 315, 320 (CCA 6th, 1941), the Court stated "The principle that one transaction may not be broken up into various elements to avoid a tax is not a single, but a double edged sword, as it also may not be broken up into various elements to create a tax".

C. *There was no taxable gain realized upon incorporation of petitioner's business (whether or not other property was received) for the reason that (1) no good will existed or its value was severely curtailed by reasons of the age and health of the proprietor and the conditions of the produce business and (2) if good will did exist, it did not exist in a form capable of transfer upon incorporation.*

The Tax Court's opinion here (App. 23) apparently endorses the Commissioners taking a position wholly inconsistent with his position in Rev. Rul. 60-301 and is subject to the following errors:

It made no attempt to distinguish its own contrary decision in *Willoughby J. Rothrock*, 7 T.C. 848 (1946), which holds that a wholesale food business is a buying and selling business and that its success is entirely due to the personal characteristics of its proprietor. It makes no at-

tempt to distinguish its own decisions in *D. K. McDonald*, 3 T.C. 720, or *Malcolm J. Watson*, 35 T.C. 203, 1960, to the effect that personal good will cannot be the subject of a transfer without an accompanying employment contract or non-competition agreement.

It ignored the testimony of a representative of the Produce Reporter Company as to the inherent nature of the produce business, and his testimony that produce businesses are nearly always liquidated, and if sold, then only at a nominal value.

As authority to sustain its position it cited the case of *John W. Harrison*, 24 T.C. 46 (1955), aff'd 235 F.2d 587 (C.A. 8; 1956), Cert. Den. 352 U.S. 952, but in that case the reason for the Court of Appeals determination against the taxpayer was that the *parties had stipulated* to the amount of good will in their proceeding before the Tax Court.

It ignored the fact that the obvious purpose for the petitioners' abortive attempt to transfer "good will" to his new corporation was a desire to obtain a maximum increased credit rating from the Produce Reporter Company.

It ignored petitioner's argument that the accountant's computation of good will had no value because it failed to consider constructive salary and that a substantial proportion of the proprietorship assets were not transferred. It ignored the obvious reason for the necessity of a credit rating in the produce business, i.e. the effect of "negative" good will must be offset by a credit rating. It ignored its own contrary holding in *Robert R. Gannon*, 21 T.C. 1073, that a wholesale business does not have transferable good

will and that a computation of "good will" which does not include proper constructive salaries is valueless.

It ignored the fact that the respondent has conceded that good will was personal to the petitioner, and other facts concerning the age, health and future prospects of the produce business.

The effect of the Tax Court's decision as affirmed by the Court of Appeals is to say that it is immaterial whether good will in fact exists but if the taxpayer once adopts a figure for good will he will be forever "hoist on his own petard" and estopped to deny the existence of "good will". If the good will had been set up in anything other than a transfer to himself, there would be a good reason for requiring the petitioner to present strong evidence to overcome it. *Ullman* v. *Commissioner*, 264 F.2d 305 (C.A. 2d, 1959).

The Court of Appeals opinion on this question (App. 32) seems to be further clouded by a very serious misconception[9] as its statement that:

> "Even accepting the taxpayer's contention that no good will was transferred to the corporation, it still had tangible assets in excess of the face of the note, thus justifying the Tax Court's finding that its market value was equal to its face since the holder of such an instrument had priority over the stockholders with respect to the corporate assets."

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[9] The Court of Appeals in *Harrison* v. *Com.*, *supra*, had a similar misconception.

appears to indicate that it believes a tax would be due even if "no good will" existed. If there were no good will, there would be no *overall* taxable gain on the exchange regardless of whether or not other property was received.

Conflicting decisions of the Tax Court should be reviewed by this Court because of the national effect of Tax Court decisions which follows as a practical result of the Tax Court's policy that it does not consider the decisions of Courts of Appeal as binding precedent unless all (or a substantial number) of the Courts of Appeal are in agreement.

D. *The obligation (Notice of Indebtedness and/or drawing account) created upon incorporation, if "other property" was not the "equivalent of cash" and, therefore, not RECEIVED within the requirement of §351 (b) IRC 1954.*

The Tax Court's opinion finds as a fact and admits (App. 21) that the notice of indebtedness was received only as evidence of an existing obligation and not in payment thereof.

For the purposes of this argument, the petitioner conceded that the "notice of indebtedness" was "other property" but it did argue in its briefs before the Tax Court and the Court of Appeals that the "other property" was not "*received*" and although taxable gain may result from the transaction, no gain *is recognized* until what he receives is the "equivalent of cash".

The opinion of neither the Tax Court or the Court of Appeals meets the issue. The Tax Court, with questionable

logic, holds the notice of indebtedness constitute "other property" and, therefore, must constitute "other property *received*" within the meaning of Section 351 (b).

The Tax Court assigns no reason for this conclusion except that in its attempt to distinguish the precedent cited by the petitioner, it implies that the use of the word "*received*" in Section 61 (a) cases bears a different connotation than the word "*received*" when used in Section 351.

That the distinction made by the Tax Court is "a distinction without a difference" is apparent from its holding that, under the provisions of Section 111 (b) IRC 1939 (§1001 (b) IRC 1954) gain is recognized upon the sale or other disposition of property only to the extent of cash or cash equivalent "*received*" and that the receipt of a contractural obligation or a non-negotiable promissory note is not the "equivalent of cash". *Nina J. Ennis*, 17 T.C. 46.

The Court of Appeals in its opinion apparently grasped the issue more acutely than did the Tax Court but, nevertheless, its logic that the taxpayer as sole stockholder would not impose a legal defense to the payment of the notice must succumb to the fact that the notice was not payable until on or after February 1, 1958 and the more logical presumption that the Taxpayer would not pay the notice to himself, or many any drawings, the practical effect of which would be to require the liquidation of his business.

Accordingly, the decision here appears to be contrary to the holding of Judge Learned Hand[10], who in denying that

[10] *Schlemmer* v. *U. S.*, 94 F. 2d 77 (CCA 2d, 1938)

a note received constituted income stated:

> "The only actual testimony was that the note was not taken as payment, but only as more permanent evidence of debt. Indeed, it is not at all clear that it would have been a cash item, even if it had in fact been taken as payment. It did not change the substance of the debt—not being endorsed or secured—and although it was more readily disposable, that single incident was scarcely enough. There would be more than mere difference in form of property to justify a charge of income."

The precise question here was not considered in either of the cases cited by the Court of Appeals: In *Lloyd Smith* v. *Comm.* 116 F.2d 642 (2 Cir. 1941) no question was raised as to whether the "other property" was "received" as the note was sold for face value in the year received. In the case of *Harrison* v. *Comm.* 35 F.2d 587 (8 Cir. 1956), Cert. Den. 352 U.S. 952, affirming 24 T.C. 46 (1955), the "cash equivalent" issue was not argued before the Court.

E. *The Notice of Indebtedness or obligation (and/or drawing account) had no fair market value or, in any event, a value substantially less than face value.*

The opinion of the Tax Court as affirmed by the Court of Appeals that the notice of indebtedness has a fair market value equivalent to its face value because of its nature as a drawing account coupled with the presumption that the petitioner as principal stockholder would not impose a legal defense to its payment, although the notice of indebtedness

and more particularly its drawing account feature was not legally authorized by the petitioner's company, ignores the effect of petitioner's express agreement not to make payments of this debt except out of profits and the binding effect of his subordination agreement with the Produce Reporter Company. This opinion also fails to consider the contrary presumption[11] that the petitioner would not make withdrawals that would endanger the operation of its business or compel its liquidation which would be required if any substantial withdrawals were made for reason that the value of the tangible assets transferred ($49,363.36) barely exceeded the face value of the notice ($48,893.46). To say that no legal significance may be attached to the fact that the notice was not legally authorized[12] since a principal stockholder would be presumed not to impose a legal defense to its payment is the equivalent of saying that in the case of a sole stockholder, the corporate entity may be ignored. Such disregard of the separateness of the corporate entity is contrary to the doctrine enunciated by the Supreme Court in *Eisner* v. *Macomber*, 252 U.S. 189, and in many other cases.

The notice of indebtedness herein is nothing more than a promise to pay money at an indefinite time in the future. As stated in *Bedell* v. *Commissioner*, 30 F. 2d 620 (C.C.A. 2d, 1929), "It is absurd to speak of a promise to pay a sum in the future as having a "market value" fair or unfair".

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[11] See *Brake & Electric Sales Corp.* v. *U.S.*, *supra*.

[12] It was stipulated and found as a fact by the Tax Court (App 8) that "This instrument (notice of indebtedness) was not adopted or ratified by any formal resolution of the stockholders or board of directors of Cash Produce".

SUMMARY OF REASONS FOR GRANTING WRIT

ARGUMENT A, ABOVE:

The time is ripe for the Supreme Court to fully consider the debt v. equity question and put its stamp of approval on the criteria that have been evolved by the various Courts of Appeal to test whether debt or equity exists. The decision here that the debt is not risk capital is contrary to the Supreme Court's decision in *John Kelley Co.* v. *Comm.*, *supra*, and to the decisions of the various Courts of Appeal, *supra*.

ARGUMENT B, ABOVE:

The Court of Appeals' disregard of the legal effect of the step (the notice of indebtedness) is contrary to the test in "step-transaction" cases adopted by the Tax Court in this case and in the Court of Appeals in *ACF-Brill Motors Co.*, 14 T.C. 263 (1950), aff'd 189 F.2d 704 (C.A. 3, 1951) cert. den. 342 U.S. 886.

ARGUMENT C, ABOVE:

The opinion of the Tax Court as affirmed by the Court of Appeals that good will exists stands for the proposition that:

(a) The taxpayer should be "hoist on his own petard", regardless of the circumstances.

(b) The Commissioner may with impunity take positions admittedly inconsistent with his own rulings.

(c) The Tax Court may with impunity disregard its own prior contrary decisions.

The question of the transferability of personal good will upon incorporation or otherwise is presently one of the most unsettled and litigated questions in the tax field. In the light of the Treasury Department's present drive on examining the tax effects of all incorporations, a decision now on this question would go far to avert potential future litigation.

ARGUMENT D, ABOVE:

The decision of the Tax Court as affirmed by the Court of Appeals that the debt (notice of indebtedness or drawing account) created upon incorporation is the "equivalent of cash" is contrary to the Tax Court's decision in *Nina J. Ennis,* 17 T.C. 465 and to the decisions of the Court of Appeals in *Schlemmer* v. *U.S.* 94 F.2d 77 (CCA 2d, 1938).

ARGUMENT E, ABOVE:

The decision of the Tax Court as affirmed by the Court of Appeals that the fair market value of the notice of indebtedness is equivalent to its face value ignores the presumption that the taxpayer would not make withdrawals which would endanger his business or result in the liquidation of his newly formed corporation and it ignores the *corporate entity* when it presumes that the petitioner's corporation would not impose a legal defense to the making of unauthorized withdrawals. The decision here is contrary to the decision in *Bedell* v. *Commissioner* 30 F.2d 620 (CCA 2d, 1929) which holds that a promise to pay money at an indefinite time in the future has no market value.

CONCLUSION

WHEREFORE, petitioners respectfully pray that certiorari be granted.

Respectfully submitted,

FORTESCUE W. HOPKINS
H. CLYDE PEARSON
509 Mountain Trust Building
Roanoke, Virginia
Attorneys for Petitioners

APPENDIX

T. C. Memo. 1961-101

TAX COURT OF THE UNITED STATES

RUFUS F. TURNER and MARGUERITE H. TURNER, Petitioners, *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 82122. Filed March 31, 1961.

Fortescue W. Hopkins, Esq., and *William N. Pierce, Esq.*, for the petitioners.

Richard C. Forman, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION.

TIETJENS, *Judge:* The Commissioner determined a deficiency in petitioners' income tax for 1957 in the amount of $11,670.36. The issues presented are (1) whether there was a recognized gain upon the incorporation of a sole proprietorship; and (2) whether a bonus received in 1957 was properly reported in that year for income tax purposes.

FINDINGS OF FACT

Some of the facts have been stipulated and are incorporated herein by reference.

Petitioners are husband and wife and reside in Martinsville, Virginia. For the calendar year 1957 they filed a joint income tax return with the director of internal revenue for the district of Virginia.

Rufus F. Turner, hereinafter referred to as petitioner, as a sole proprietor, had engaged in the operation of a fresh produce wholesale grocery business for 36 years in Martinsville under the name of Cash Produce Company. Also associated with the business were petitioner's wife, Marguerite H. Turner, who had been employed for 26 years as a bookkeeper, and James R. Ingram, petitioner's son-in-law, who had been employed for 7 years and was petitioner's principal assistant.

On November 14, 1956, petitioner incorporated the sole proprietorship under the name of Cash Produce Company, Inc., hereinafter referred to as Cash Produce. The corporation transacted no business until January 1, 1957. A stock statement was filed with the Virginia State Corporation Commission on December 6, 1956, advising it of a plan to issue 135 shares of common stock for $6,750 in cash. Also in December 1956, petitioner conferred with his attorney and his certified public accountant with respect to the manner in which to accomplish the proposed transfer of the proprietorship assets to the new corporation. At that time the accountant made the following computation of the proprietorship goodwill:

Net earnings (before income taxes)—		
1952	$ 29,887.34	
1953	18,468.80	
1954	19,536.61	
1955	24,830.86	
1956	21,535.87	
Total	$114,259.48	
Less income taxes—25% average	28,564.87	
Total net earnings	$ 85,694.61	
5 year average	$ 17,138.92	
Net earnings capitalized at 10%		$171,389.20
Less net invested capital at 12-31-56 exclud-		

ing goodwill (75,534.48 + 21,535.87)		97,070.35
Goodwill at date of incorporation		$ 74,318.85
Rounding off	$ 74,300.00	

On January 1, 1957, with the exception of real estate and certain other fixed assets, all of the assets of the sole proprietorship together with certain liabilities were transferred to Cash Produce in exchange for 1,365 shares of common stock. These assets had a cost basis of $49,593.46. A summary of the balance sheet of the proprietorship as of December 31, 1956 was as follows:

Current Assets		$ 47,077.44
Fixed Assets	$ 91,455.07	
Less Depreciation	36,490.09	54,964.98
Other Asset		230.10
TOTAL ASSETS		$102,272.52
Current Liabilities		$ 5,202.17
R. F. Turner, Capital:		
Balance 1-1-56	$116,013.78	
Earnings for year 1956	21,535.87	
	$137,549.65	
Drawings for 1956	40,479.30	97,070.35
TOTAL LIABILITIES		$102,272.52

The following is the opening journal entry as of January 1, 1957 on the books of Cash Produce prepared by its attorney:

	Debit	Credit
Cash	$ 9,092.61	
Accounts receivable	12,339.46	
Inventory	25,645.37	
Store fixtures	996.30	
Cars and trucks	20,273.91	
Office equipment	3,111.87	
Frigidaire air conditioners	620.21	
Incorporation expense	230.10	
Goodwill	74,300.00	
Reserve for depreciation—store fixtures		$ 481.53
Reserve for depreciation—cars and trucks		15,449.23
Reserve for depreciation—office equipment		1,433.56
Reserve for depreciation—air conditioners		149.88
Accounts payable—trade		2,312.01
Reserve for withholding tax		625.02
Accrued salaries		2,024.58
Accrued social security taxes		240.56
Note payable—R. F. Turner		48,893.46
Capital stock subscribed		68,250.00
Capital stock issued		6,750.00

To record acquisition of business assets from R. F. Turner in exchange for capital stock of the corporation and account due R. F. Turner.

A financial statement for Cash Produce as of January 1, 1957 was prepared by the accountant on January 19, 1957, and transmitted to the Produce Reporter Company, Wheaton, Illinois which publishes a credit rating reference book of produce firms. The following is the balance sheet from that financial statement:

CURRENT ASSETS		
Cash	$ 9,002.61	
Accounts receivable—customers	12,339.46	
Merchandise inventory—at the lower of cost (determined by the first-in-first-out method) or market	25,645.37	$ 47,077.44
FIXED ASSETS		
Store fixtures, furniture equipment and vehicles—at cost	$ 25,002.29	
Less accumulated depreciation	17,514.20	7,488.09

INTANGIBLE ASSETS			
Good Will		$ 74,300.00	
Incorporation expense		230.10	74,530.10
TOTAL ASSETS			$129,095.63
CURRENT LIABILITIES			
Accounts payable:			
Trade	$ 2,312.01		
Other	625.02	$ 2,937.03	
Accrued liabilities:			
Salaries and wages	$ 2,024.58		
Taxes (other than taxes on income)	240.56	2,265.14	$ 5,202.17
NONCURRENT LIABILITY			
unsecured and without interest			48,893.46
Note payable to officer—			
CAPITAL			
Common stock—authorized, 3,000 shares of $50 par value; issued and outstanding, 135 shares		6,750.00	
Subscriptions to common stock, 1,365 shares		68,250.00	75,000.00
TOTAL LIABILITIES			$129,095.63

Thereafter petitioner received the following reply from the Produce Reporter Company in regard to the financial statement submitted:

> The statement of Cash Produce Company, Inc., does present several problems from a rating standpoint.
>
> The item of "good will" is very correctly listed as a "intangible asset", it is the type asset which is eliminated from credit consideration in arriving at Blue Book financial ratings.
>
> When your good will and incorporation expenses of $74,530.10 are eliminated from your statement, that January 1, 1957 Corporation financial statement then shows a net worth of less than $500.

We believe we have a feel of what your accountant and tax attornies [*sic*] have attempted to accomplish in handling your incorporation on a basis which provides for a corporation note payable "to officer" of $48,893.46. Such an arrangement does, however, deplete completely the corporation's financial responsibility for credit rating purposes.

Your accountant can, of course, advise you on the advisability of issuing corporate stock for that indebtedness to officers.

Frankly, Mr. Turner, we hesitate very much to recommend a subordination agreement covering the notes payable to officers and do so only as a last resort. In the event your accountants or attornies [*sic*] would want to prepare a subordination agreement which would clearly set forth that no payments are to be made on indebtedness to officers as long as there are any trade obligations and indicate clearly that you will notify Produce Reporter Company prior to the time any payment is made on that indebtedness, then such a subordination agreement could be accepted.

It is the type exception, however, which is "loaded" with possibilities of misunderstanding for the future.

* * * *

In response to this letter petitioner wrote the following:

As principal stockholder, president and manager of Cash Produce Co., Inc. the undersigned will continue to honor credit extension with the same integrity and ability as in the past, and to personally guarantee

payment of the corporations debts in the same manner as prior to incorporation.

Though you suggest in your letter that a subordination agreement as to the corporations debt to me is "loaded" with possibilities of misunderstanding, you may accept this letter over my signature below as such an agreement, to the effect hat any trade obligations will most certainly be paid before any liquidation of this debt. Any drawings I made from the corporation above the minimal salary allowance provided for me will be charged against my annual profit-sharing. Furthermore, your letter ignored the fact that the note payable to officer of $48,893.46 was created by the charge for goodwill, and that the goodwill was a capitalization at 10% of the average net profits of the past five years. * * *

Nevertheless, to eliminate goodwill from credit consideration as you state, should also require elimination of the debt which it created, leaving a remaining net worth of $49,363.36. To the latter should be added, if not more, by the subordination described above, the value of the business real estate which I retained in my own right in the amount of $47,476.89, giving a total net worth for credit purposes (Excluding other personal assets) in the amount of $96,840.25, exclusive of goodwill.

* * * *

As evidence of the $48,893.46 designated on the balance sheet submitted to the Produce Reporter Company as "NONCURRENT LIABILITY, Note Payable to officer—unsecured and without interest", the accountant prepared

the following instrument which was executed sometime between January and November 1957:

Notice of Indebtedness

January 1, 1957

For value received, We, Cash Produce Co., Inc., do hereby promise to pay to Mr. Rufus F. Turner, his heirs or assigns, the amount of Forty-eight thousand, eight hundred, ninety-three dollars and forty-six cents, ($48,893.46) without interest, payable at the office of the corporation on or after February 1, 1958; also the corporation is not to furnish security of any type for this indebtedness. It is also agreed that the payee may draw funds from the corporation at any time upon the pledge of this note as security, said drawings to be deducted from the amount of this liability prior to settlement.

Accepted and agreed to the above this date January 1, 1957.

(S) Rufus F. Turner
Payee

Cash Produce Co., Inc.
(S) Rufus F. Turner
Registered Agent
President

This instrument was not adopted or ratified by any formal resolution of the stockholders or the board of directors of Cash Produce.

A meeting of the board of directors of Cash Produce was held on February 25, 1957. Relevant parts of the minutes of that meeting are as follows:

WHEREAS, Rufus F. Turner, sole proprietor and owner, trading and doing business previously as the Cash Produce Company, Martinsville, Virginia, has the below mentioned personal property assets of $129,095.63, and said Rufus F. Turner, owner and sole proprietor, being subject to liabilities of $54,-095.63, he having previously purchased for cash 135 shares at $50.00 per share for $6750.00 cash; therefore, total liabilities outstanding by purchase of said stock being the sum of $60,845.63; and the difference between said assets and liabilities being net assets and net worth of $68,250.00, and he has offered to sell the personal assets of said Cash Product [*sic*] Company for the below sum, subject to said liabilities, with the remaining value in net assets and worth of $68,250.00 to the Cash Produce Company, Incorporated payable in common stock of the Corporation, representing the difference between the assets subject to said liabilities.

WHEREAS, the said Rufus F. Turner, owner, has offered to transfer the said current, fixed and intangible personal property assets of said Cash Produce Company with the assumption of said liabilities to the Cash Produce Company, Incorporated, in exchange for $68,250.00 to be paid in 1365 shares of the capital stock of the corporation of the par value of $50.00 each, and it is necessary for this Board of Directors to determine the value of such property in current money of the United States of America, as well as to accept or reject the said offer:

NOW, THEREFORE, BE IT RESOLVED:

First, that this Board, in the exercise of its best skill

and judgment, fixes and determines the value of the said property in current money of the United States in accordance with the Financial Statement of Cash Produce Company, Incorporated of January 1, 1957, as successor to Cash Produce Company (Rufus F. Turner, sole proprietor) on January 1, 1957, prepared by Alexander Grant & Company, certified public accountants of Roanoke, Virginia on January 19, 1957 and said Statement of the valuation of the assets and liabilities as set forth in said Statement, a copy of which is hereby attached and incorporated in the within resolutions and said balance sheet of said assets and liabilities of said Statement is hereby adopted as follows:

[This balance sheet is identical with the one submitted to Produce Reporter Company, set out above.]

Second, that the said offer of the said Rufus F. Turner, owner, trading as the Cash Produce Company, Martinsville, Virginia, be, and the same hereby is, accepted, in the sale of the above valued assets of $129,095.63, subject to the liabilities of $54,095.63, to the Cash Produce Company, Incorporated, and that 1365 share of the common stock of the par value of $50.00 each in the total sum of $68,250.00 of said Corporation be issued, (in addition the amount $6750.00 has previously been issued to him by said Corporation, to cover the actual net worth and net Corporation for cash) and the remaining amount of $68,250.00 now be issued to Rufus F. Turner by said assets as shown in the First Resolution above.

A fiscal year ending July 31 was adopted by Cash Produce. Petitioner's wife, as bookkeeper, incorrectly credited

the $48,893.46 to "Accounts Payable" and subsequently certain drawings of petitioner were debited to this account with the result that the financial statement of Cash Produce for its fiscal year disclosed notes payable as $42,000.29. This error was corrected in January 1958 when the accountant audited petitioner's drawing account in preparation of the joint income tax return.

On November 15, 1957, the accountant left the firm by which he had been employed and shortly thereafter opened his own office in Martinsville. On January 1, 1958, petitioner and Cash Produce became the accountant's clients. On or about January 8, 1958, the accountant's immediate supervisor of his former firm telephoned him and also advised petitioner by letter that the incorporation of Cash Produce was, in the supervisor's opinion, taxable rather than tax free.

On January 14, 1958, a debenture bond in the amount of $48,893.46 issued by Cash Produce to petitioner was filed with the Virginia State Corporation Commission. Although this debenture bond was dated January 1, 1957, it was prepared by Cash Produce's attorney from a form supplied by the accountant a few days prior to the filing. Pertinent provisions of this debenture bond are as follows:

> Cash Produce Company, Incorporated, a Corporation organized and existing under the laws of the State of Virginia, (hereinafter called the "Corporation"), for value received, hereby promises to pay to Rufus F. Turner, or order, his heirs or assigns, the total sum of $48,893.46, bearing interest at three per cent (3%) per annum, and being payable as follows: $5,000.00 on January 1, 1962, and $5,000.00 on the

first day of each year thereafter until the total sum of $48,893.46 herein owed is paid unto the said Rufus F. Turner, or order, his heirs or assigns, together with 3% interest per annum and with the first payment of interest being due and payable on said sum on January 1, 1958 and on the first day of each year thereafter.

The issue of the within corporate debenture is made and executed pursuant to the articles of incorporation of the said Corporation and in pursuance of a resolution of said Corporation passed on the 1st day of January, 1957 and said debenture herein being debenture No. 1.

* * * *

This debenture is of an authorized issue debenture due as hereinabove set forth of the Corporation (hereinafter called debenture) of the aggregate principal amount of Forty-Eight Thousand Eight Hundred Ninety-Three Dollars and Forty-Six Cents ($48,893.46), duly authorized by resolution of the Board of Directors of the Corporation adopted January 1, 1957.

The liability reflected in the debenture bond was recorded on the books of Cash Produce by the accountant as a "Long-Term Liability" with the explanation "Indenture due Rufus F. Turner from transfer of assets at date of incorporation." Although entered on the books in January 1958 it was dated January 1, 1957.

One of the closing journal entries of Cash Produce for the fiscal year ended July 31, 1957 was as follows:

Officers' salaries	$12,000.00	
Payroll taxes	55.12	
Social security tax payable		110.25
Withholding taxes		1,919.88
R. F. Turner—accounts payable		24.99
Capital stock		10,000.00
To record additional salary paid to R. F. Turner in corporate common stock.		

A "Stock Statement" dated January 10, 1958 was filed with the State Corporation Commission. It recited that "200 shares common stock at $50.00 per share in one issue [were] to be issued for * * * $10,000 in cash."

The Commissioner explained in the statement accompanying the statutory notice of deficiency:

> It is held that you realized a gain of $74,300.00, recognized as a long-term capital gain to the extent of $48,893.46 (taxable at 50%), which represents the fair market value of non-interest bearing note received as part payment in the transfer of your net equity in assets to the Cash Produce Company, Incorporated. Therefore, taxable income has been increased in the amount of $24,446.73.

In an amended petition petitioners allege that they erroneously reported as income in 1957 stock or a bonus in the amount of $10,000.

OPINION.

The tax incidents of a transfer of property to a new corporation are ascertained by reference to section 351,[1]

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[1] SEC. 351 [1954 Code]

(a) General Rule.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in

Internal Revenue Code of 1954, which is a substantial reenactment of section 112(b)(5) of the 1939 Code. Under section 351 the recognition of gain or loss at the time of incorporation is postponed if the transfer complies with the requisites of the statute which were framed in light of the underlying philosophy of the section, that an incorporation is a mere change in the form of doing business. Section 351 provides, in effect, that "no gain or loss shall be recognized" on the transfer of property to a corporation if (1) the transfer is "solely in exchange for stock or securities in such corporation" and (2) the transferor has an 80 per cent control of such corporation "immediately after the exchange." Section 351(b) contains a caveat that if property other than stock or securities permitted to be received without the recognition of gain or loss is obtained in the exchange, any gain on the transfer shall be recognized, but "not in excess of" the fair market value of such "other property" or if money, the amount of money received. No loss shall be recognized.

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exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) Receipt of Property.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsction (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

(c) Special Rule.—In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in exchange to its shareholders shall not be taken into account.

In the instant case, the Commissioner determined that petitioner received in the incorporation of Cash Produce not only "nonrecognition" property, but also "other property" in the form of a non-interest bearing note in the amount of $48,893.46. He determined further that the petitioner had realized a gain of $74,300 on the transfer and consequently there was a recognized gain taxable as a long-term capital gain to the full extent of the face value of the note.

In contesting the Commissioner's determination the petitioner argues (1) that the incorporation was entirely tax free as the "Notice of Indebtedness" was not a legal instrument, but only a memorandum prepared for petitioner's personal satisfaction until a debenture bond was issued and that the petitioner's receipt of such debenture bond on January 14, 1958 was an integral and concluding step in the plan of incorporation; (2) that the notice of indebtedness does not constitute "other property" within the concept of section 351; (3) that even if the notice of indebtedness is "other property" it had no fair market value; (4) that if it is "other property" and in addition had a fair market value, nevertheless no gain was realized upon the receipt of the stock and "other property" because the value of the property received was not in excess of the net adjusted cost basis of the tangible assets transferred; and (5) that the notice of indebtedness represented an equity interest equivalent to stock.

The petitioner's initial proposition is that the transactions were merely steps in a "single scheme" of incorporation. The question of whether a transaction is a part of a preconceived plan of incorporation is primarily factual. In *Manhattan Building Co.*, 27 T.C. 1032 (1957) we said,

at page 1042: "The test is, were the steps taken so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." See also *ACF-Brill Motors Co.*, 14 T.C. 263 (1950), affd. 189 F. 2d 704, certiorari denied 342 U.S. 886 (1951).

In the instant case the resolution of this question turns upon the legal effect of the notice of indebtedness. Petitioner claims it had no legal significance, but was merely a memorandum prepared for his personal satisfaction until the issuance of the debenture bond. The Commissioner, on the other hand, says it was a note issued in conjunction with the incorporation and had no relation to the subsequent issuance of the debenture bond.

Although labeled a "Notice of Indebtedness", the instrument provided that

> *For value received*, We, Cash Produce Co., Inc., *do hereby promise to pay to Mr. Rufus F. Turner, his heirs or assigns, the amount of Forty-eight thousand, eight hundred, ninety-three dollars and forty-six cents, ($48,893.46) without interest payable at the office of the corporation on or after February 1, 1958;* also the corporation is not to furnish security of any type for this indebtedness. It is also agreed that the payee may draw funds from the corporation at any time upon the pledge *of this note* as security, said drawings to be deducted from the amount of this liability prior to settlement. [Emphasis supplied]
>
> Accepted and agreed to the above this date January 1, 1957.

(S) Rufus F. Turner
Payee

CASH PRODUCE CO., *Inc.*
(S) Rufus F. Turner
Registered Agent
President

As can be seen, no reference to an execution of a debt obligation in the future was embodied in the so-called "Notice of Indebtedness", and though there may be some doubt as to its negotiability, the instrument on its face appears to be more than a memorandum as it contains all the indicia of an enforceable obligation to pay money. Virginia Code § 8-509.[2] There also seems to be an inconsistency between the label of the instrument and its designation as a "note" in the body of the writing.

Inasmuch as such a construction is contrary to the intent of petitioner as testified to at the trial, it is necessary to examine the surrounding facts and circumstances to ascertain if they substantiate petitioner's contention.

Under the terms of the notice of indebtedness petitioner could "draw funds from the corporation at any time upon the pledge of [the] note as security, said drawings to be deducted from the amount of [the] liability prior to settlement". This is in essence a drawing account of $48,893.46

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[2] Code of Virginia—§ 8-509.

Civil action on note or writing promising to pay money. A civil action may be maintained upon any note or writing by which there is a promise, undertaking, or obligation to pay money, if the same be signed by the party who is to be charged thereby, or his agent. * * *

as petitioner could draw funds up to that aggregate amount from the corporation. Petitioner disaffirms any intention of withdrawing such amounts; however, an examination of the balance sheet of the sole proprietorship in 1956 discloses that petitioner's drawings in that year exceeded $40,000. The fact that no withdrawals were made in 1957 can be explained by the subordination agreement petitioner entered into with Produce Reporter Company. Petitioner was quite concerned about maintaining a high credit rating which, from the testimony, was deemed to be a necessity in the produce business. The correspondence between petitioner and Produce Reporter Company in the findings of fact clearly illustrates that petitioner could make no withdrawals without seriously impairing the corporation's credit standing. Petitioner's reply to Produce Reporter Company which contained the informal subordination agreement made no mention of an intended debenture bond, but he did make it clear that "any trade obligations" would be paid "before liquidation" of the debt and that "any drawings" would be charged against his "annual profit sharing".

The argument by petitioner that a pro-forma balance sheet prepared by the accountant in 1956 to reflect the proposed incorporation referred to a "Note payable—long term" has little significance at the time for payment set out in the notice of indebtedness was not for at least 13 months and under good accounting principles should have been so categorized for balance sheet purposes. Accountants' Handbook (4th Ed.) sec. 20.2. A more controlling factor we think is that the debt obligation contained in both the balance sheet incorporated into the minutes of the board of directors' meeting and the balance sheet submitted to Produce Reported Company was designated as a

"NONCURRENT LIABILITY—Note payable to officer—unsecured and without interest". This description very adequately describes the notice of indebtedness as it contained all the requisites of a note, was specifically stated to be unsecured and did not bear interest. It would also be properly characterized as a "noncurrent liability" as it was not payable during the corporate year ending July 31, 1957. Conversely, the debenture bond was, as its name indicates, a bond extending over a relatively long period of time which provided for the payment of interest.

Petitioner submits that a further impediment in construing the notice of indebtedness as a note is the lack of authorization by the board of directors. The minutes of the board of directors' meeting on February 25, 1957, show:

> NOW, THEREFORE, BE IT RESOLVED:
>
> First, that this Board, in the exercise of its best skill and judgment, fixes and determines the value of the said property in current money of the United States in accordance with the Financial Statement of Cash Produce Company, Incorporated of January 1, 1957, * * * said Statement of the valuation of the assets and liabilities as set forth in said Statement, a copy of which is hereby attached and incorporated in the within resolutions and said balance sheet of said assets and liabilities of said Statement is hereby adopted as follows:
>
> * * * * * * * *
>
> NONCURRENT LIABILITY
>
> Note payable to officer—
>
> unsecured and without interest $48,893.46
>
> * * * * * * *

If the notice of indebtedness and the "noncurrent liability" contained in the balance sheet incorporated into the minutes of the board of directors' meeting are one and the same, as we think they are, such incorporation is sufficient authorization. It should be noted while commenting on the topic of authorization that there is a recitation in the debenture bond that it was "executed pursuant to the articles of incorporation of the said Corporation and in pursuance of a resolution of said Corporation passed on the 1st day of January, 1957". The petitioner produced neither the articles of incorporation nor the resolution which supposedly authorized the issuance of the debenture bond.

From the afore-going enumerated factors it can be seen that not only the instrument, but also the peripheral facts and circumstances contravene the petitioner's contention that the notice of indebtedness was merely intended to be a memorandum. To base our decision solely upon the declared intention of the petitioner unsupported by the evidence would be to disregard completely the realities of the situation. As we view the evidence we do not find such an "interdependent" relationship so as to justify a conclusion that a "single scheme" of incorporation existed of which the issuance of the debenture was the final step.

Our view of the evidence is that the transaction was cast as depicted by the Commissioner, with the petitioner receiving in return for the assets transferred, stock and a note which entitled him to draw funds from the corporation at will. This plan, however, was inadvertently thwarted when petitioner discovered that such withdrawals would affect the credit rating of the corporation. And later, in January 1958, when it was discovered that the incorporation might not be entirely tax-free, an antedated debenture

bond which related back to the time of the incorporation was prepared by the attorney to shore up the transfer and render the entire exchange tax-free and the accountant at that time entered a new account on the books of the corporation entitled "Long-Term Liability" with the explanation "Indenture due Rufus F. Turner from transfer of assets at date of incorporation" which was dated January 1, 1957 to conform to the issuance date of the debenture bond.

The next approach taken by petitioner is that the notice of indebtedness does not constitute "other property" within the meaning of section 351(b). This contention is not predicated upon an agreement that the notice of indebtedness was a security under section 351(a), but rather that the notice of indebtedness was received by petitioner only as evidence of an existing obligation and not in payment of an obligation. We agree with petitioner that the notice of indebtedness is written evidence of an existing enforceable obligation. However, we do not agree that this is not "other property" within the purview of section 351(b). Petitioner cites *Jay A. Williams*, 28 T.C. 1000 (1957) and extracts from context our statement that "A note received only as security, or as an evidence of indebtedness, and not as payment, may not be regarded as income". In *Williams* we dealt with the question of whether a note received in payment of services was income to the recipient. We held the note was not income as it was established to our satisfaction that the note was not received in payment of the outstanding debt due the taxpayer for the performance of services and that "a simple change in the form of indebtedness from an account payable to a note payable is insufficient to cause the realization of income by the creditor".

It is obvious that petitioner by this contention has completely misconceived the import of the note in this case. The question presented here is not whether the receipt of the note resulted in ordinary income under section 61(a) *Schlemmer* v. *United States*, 94 F. 2d 77 (C.A. 2, 1938); *Robert J. Dial*, 24 T.C. 117 (1955); *Jay A. Williams*, *supra*, but whether gain was recognizable on the incorporation as a result of the receipt of the note under section 351. Our afore-going conclusion was that the notice of indebtedness was an enforceable note and the cases have uniformly held that a note of such duration does not comply with the statutory concept of a security. *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462 (1933); *Cortland Specialty Company* v. *Commissioner*, 60 F. 2d 937 (C.A. 2, 1932), certiorari denied 288 U.S. 599 (1933); *Lloyd-Smith* v. *Commissioner*, 116 F. 2d 642 (C.A. 2, 1941); *Neville Coke & Chemical Co.*, 3 T.C. 113 (1944), affd. 148 F. 2d 599 (C.A. 3, 1945), certiorari denied 326 U.S. 726 (1945); *Camp Wolters Enterprises, Inc.*, 22 T.C. 737 (1954), affd. 230 F. 2d 555 (C.A. 5, 1956), certiorari denied 352 U.S. 826 (1956). Inasmuch as it does not qualify as a security under section 351(a), it is "other property" under section 351(b). Rev. Rul. 56-303, 1956-2 C.B. 193.

Petitioner continues, that even if the notice of indebtedness is "other property" it had no fair market value. He says that it is apparent from the financial condition of the corporation and the testimony of the parties concerned that there was no immediate intention or ability to pay the obligation. The evidence does not disclose an inability on the part of the corporation to pay the note. Although there was evidence regarding the value of the note it was focused primarily on the aspect of its value as collateral security

for a loan. There is a question as to whether it could be discounted; however, it should be kept in mind that, as previously indicated, this note was not an ordinary note whose value would increase as the maturity date approached, but was *sui generis*, as its provision that "the [petitioner] may draw funds from the corporation at any time upon the pledge of [the] note as security, said drawings to be deducted from the amount of [the] liability prior to settlement" made it in effect a drawing account. As we see it, the fair market value of the note was at all times its stated value as petitioner at any time could have withdrawn such amounts, the only barrier to such withdrawals being the voluntary, self-imposed subordination agreement which could have been rescinded at any time by petitioner. We do not think that the evidence introduced establishes that the amount determined by Commissioner to be the fair market value is arbitrary or unreasonable.

Petitioner in another phase of his assault upon Commissioner's determination argues that if we should find that the note has a fair market value nevertheless petitioner realized no gain on the transfer for the reason that the value of the stock and "other property" received was not in excess of the net adjusted cost basis of the tangible assets transferred. Simply stated, petitioner contends that the $74,300 which was ascribed to goodwill at the time of the incorporation was incorrect and that no goodwill existed or was transferred, or, if any was transferred, its value was negligible. The Commissioner says that the sole proprietorship possessed transferable goodwill with a value of $74,300. This presents a paradox as petitioner now attempts to retreat from his original position by relying on *Willoughby J. Rothrock*, 7 T.C. 848 (1946) and a ruling, Rev. Rul. 60-301, I.R.B. 1960-38, 7, in which the

Commissioner challenged the transfer of goodwill. Conversely, the Commissioner here does not challenge, but acquiesces in the original amount designated by petitioner as goodwill. In addition to the afore-mentioned case and ruling, petitioner also calls attention to the testimony of a representative of Produce Reporter Company who stated that goodwill had no value in arriving at a rating for a produce business. A query from the Court revealed that this rating was from the standpoint of a creditor rather than a possible purchaser and that all assets were viewed in regard to their basis at liquidation in order to ascertain their worth to creditors in the event of such liquidation. This sheds little light upon the problem.

We are convinced that the corporation acquired something more in value at the incorporation of the sole proprietorship than the tangible assets transferred, which was goodwill; and petitioner has not shown the Commissioner's determination of the amount of this goodwill to be erroneous. See *John W. Harrison*, 24 T.C. 46 (1955), affd. 235 F. 2d 587 (C.A. 8, 1956), certiorari denied 352 U.S. 952. It follows that the Commissioner's determination must be sustained.

It is unnecessary to discuss petitioner's final contention, that the notice of indebtedness represented an equity interest equivalent to stock, in view of our holding that the notice of indebtedness is a note.

The second issue presented is whether petitioner improperly reported the receipt of a $10,000 bonus on his joint return for the year 1957. Petitioner claims: (1) that the bonus was not formally authorized by the corporation until January 7, 1958; (2) that the stock issued was not

authorized by the State Corporation Commission to be issued until after January 7, 1958; and (3) that even if the stock was constructively received by petitioner on July 31, 1957, it had no substantial value at that time.

As shown in the findings of fact, one of the closing entries of the corporation on July 31, 1957, credited "Capital stock" with $10,000, "To record additional salary paid to R. F. Turner in corporate common stock". A reference to this transaction was embraced in the minutes of the board of directors' meeting on January 7, 1958. It stated that

> Having been previously approved by the board of directors the board voted unanimously to approve the payment of a bonus of $12,000.00 for the year ending July 31, 1957 to R. F. Turner, the president. Mr. R. F. Turner advised that after various withholdings that he had used the remainder of the sum of $10,000.00 in the purchase of 200 shares of the common stock at $50.00 per share to be issued and dated July 31, 1957.

As we interpret the statement from the minutes of the board of directors meeting, the bonus was a cash bonus of $12,000 which had "been previously approved by the board of directors". Petitioner then used "the sum of $10,000.00 in the purchase of 200 shares of the common stock [of the corporation] at $50.00 per share". Such an interpretation is in accord with a "Stock Statement" filed with the State Corporation Commission on January 10, 1958, which contained the recitation that "200 shares [of] common stock at $50.00 per share in one issue [were] to be issued for $10,000 *in cash*". [Emphasis supplied]. It

should be noted that at the bottom of the "Stock Statement" it states that "Rufus F. Turner, being first duly sworn, deposes and says * * *. The facts set forth in the statement are true." followed by the signature of petitioner.

The utilization of a part of the proceeds of the cash bonus to purchase corporate stock which was not authorized and issued until 1958 has no impact upon the proper reporting of the cash bonus for income tax purposes. We are convinced that petitioner's attempted repudiation of the transaction now, by claiming it was not a cash but rather a stock bonus is not supported by the facts and we disregard as irrelevant the arguments advanced by petitioner concerning the authorization, issuance and valuation of the corporate stock. The Commissioner must be sustained on this issue also.

Decision will be entered for the respondent.

[Caption Omitted]

OPINION U.S. COURT OF APPEALS

J. SPENCER BELL, Circuit Judge:

This is an appeal from a decision of the Tax Court sustaining the Commissioner's determination of a deficiency of $11,670.36 in income tax for the year 1957 of the petitioners, Rufus F. Turner and wife, Marguerite H. Turner, hereafter referred to as Turner. The appeal involves two questions: first, whether the taxpayer received property other than stock and securities within the provisions of

§351(b) of the Internal Revenue Code of 1954; and second, whether the taxpayer received a taxable bonus of $10,000.00 in the year 1957.

Prior to January 1, 1957, Turner was engaged in the fresh produce wholesale grocery business in the town of Martinsville, Virginia, as a sole proprietor. In November, Turner caused a Virginia corporation to be set up under the name of Cash Produce Company, Inc. On January 1, 1956, upon the advice of his accountant and attorney, 1957, certain tangible assets of Turner's sole proprietorship having a cost basis of $49,493.46; the good will of the business, which his accountant computed to be worth $74,300.00, and all of its liabilities were transferred to the corporation in exchange for 1,365 shares of stock. The opening statement of the corporation showed a debit item under the following heading: "Non current liability—note payable to officer—unsecured and without interest of $48,893.46".

On January 25, 1957, the Board of Directors of the corporation met and adopted a resolution approving the transfer of assets and assumption of liabilities as shown on the opening statement and the issuance of capital stock therefor. This statement showed the total value of the assets to be $129,095.63 subject to liabilities of $54,095.63 (this item included the note payable to officer). At some time between February and November 1957 the accountant, Ford prepared for Turner an instrument which purported to reflect the nature of this corporate liability to Turner, who was the officer referred to in the debit item above. The instrument read as follows:

"Notice of Indebtedness

January 1, 1957

"For value received, We, Cash Produce Co., Inc., do hereby promise to pay to Mr. Rufus F. Turner, his heirs or assigns, the amount of forty-eight thousand, eight hundred, ninety-three dollars and forty-six cents, ($48,893.46) without interest, payable at the office of the corporation on or after February 1, 1958; also the corporation is not to furnish security of any type for this indebtedness. It is also agreed that the payee may draw funds from this corporation at any time upon the pledge of this note as security, said drawings to be deducted from the amount of this liability prior to settlement.

"Accepted and agreed to the above this date January 1, 1957.

"(S) Rufus F. Turner
Payee

Cash Produce Co., Inc.
(S) Rufus F. Turner
Registered Agent
President"

On January 14, 1958, a debenture bond of $48,893.46 was issued by the corporation payable to Turner. Although this bond was executed and filed with the Virginia State Corporation Commission on January 14, 1958, it was dated January 1, 1957. It was conceded by the Commissioner that this bond would constitute a security within the meaning of Section 351(a).

A journal entry for the corporation on July 31, 1957,

(the close of its first fiscal year) showed a salary payment of $12,000.00 to Turner with a notation that $10,000.00 of that sum was transferred to the capital stock fund of the corporation and the further notation: "To record additional salary paid to R. F. Turner in corporate common stock." The minutes of the annual meeting of the stockholders held on January 7, 1958, reflect the following entry with respect to that transaction: "Having been previously approved by the Board of Directors the Board voted unanimously to approve the payment of a bonus of $12,000.00 for the year ending July 31, 1957, to R. F. Turner, the President. Mr. R. F. Turner advised that after various withholdings he had used the remainder of the sum of $10,000.00 in the purchase of 200 shares of common stock at $50.00 per share to be issued and dated July 31, 1957". A report to the State Corporation Commission dated January 10, 1958, recited that 200 shares at $50.00 per share were to be issued for $10,000.00 in cash.

The taxpayer contends that the indenture issued on January 14, 1958, was the final step of the plan to incorporate the business and that it was an integral part of the plan from its beginning; that its issuance was delayed by his accountant and his attorney while they were searching for a proper form. The testimony of both the attorney and the accountant supported the taxpayer in this respect. The attorney testified that when the taxpayer and his accountant came to his office in November 1956 Mr. Turner was primarily concerned with problems of his health and how he could obtain funds from the business after his retirement. The accountant confirmed this and stated that he had proposed an indebtedness from the corporation and that he had expressly warned the parties that the proposed indebtedness must be reflected in a long term debenture

bond in order to avoid tax consequences at the time of incorporation, and also satisfy Mr. Turner's desire for a source of funds after he reached sixty-five. The taxpayer, therefore, argues that the transaction considered as a whole is tax free because the only things which he received in exchange for the assets of his proprietorship were the stock and the indemnity bond delivered to him on January 14, 1958. He contends that the so-called "Notice of Indebtedness" was merely a temporary memorandum of the debt and without tax significance.

The Commissioner contends otherwise, and the Tax Court has accepted his contentions, holding that the "Notice of Indebtedness" was an effective debt instrument constituting "other property" within the meaning of Section 351(b); that it was received by the taxpayer as "boot" along with his stock in exchange for his proprietorship assets, and was therefore taxable. Upon this record we are not able to say that the court was clearly in error. All of the contemporaneous written evidence supports the court's findings, and if it does not actually negate the contention of the taxpayer it is at the least no more compatible with those contentions than with the court's findings. In such a situation it is peculiarly within the province of the fact finding agency to make the necessary determination. *Commissioner* v. *Duberstein*, 363 U.S. 278 (1960). It is obvious that the testimony of both the accountant and the attorney was substantially rejected by the court insofar as their original intentions or their subsequent conduct in preparing the indenture were attributed to the taxpayer or his corporation. However, the decision of the court is not wholly incompatible with their testimony. It is conceivable that at the planning meetings in November and December of 1956 these gentlemen decided that the corporate indebtedness

to Turner should be reflected in a tax free long term debenture bond within the provisions of Section 351(b), but as time went on and the bond was not forthcoming Mr. Turner grew impatient, and especially when he learned that Mr. Ford was severing his connections with the accounting firm which was handling his business. Mr. Turner insisted upon some evidence of the indebtedness which he could "hold in his hands". (At this point it was Turner's intentions and conduct which became legally effective rather than that of his professional advisers.) Thus the issuance of the "Notice of Indebtedness" was not a step in an integrated plan conceived from the beginning but a change in plan which upset the original calculations of his professional advisers with unfortunate tax consequences to Mr. Turner. Thus it was their conclusions with respect to the legal consequences of the issuance of the "notice" which the court rejected rather than the factual testimony of these witnesses.

We now come to the taxpayer's alternative contentions with respect to the legal effect of the "Notice of Indebtedness".

Counsel has carefully and ably prepared an elaborate series of alternative positions to which he withdraws in stubborn resistance of defeat, but we fear that they must fall with the collapse of his main line of defense.

Second in importance to the court's finding that the debenture bond issued on January 14, 1958, was not a final and concluding step in an over-all plan was the court's finding that the good will of the business which was transferred to the corporation was properly evaluated by its accountant at $74,300.00. The contemporaneous conduct

and declarations of this accountant as the man most familiar with taxpayer's business are certainly substantial evidence to support the court's findings.

In outline the transaction consisted of a transfer of certain tangible assets plus good will to a corporation in exchange for stock and either a short term note or a drawing account. Since the transaction would be taxable in either event we, therefore, see no reason to draw any fine distinction between the two. *Harrison* v. *Commissioner of Internal Revenue*, 235 F.2d 587 (8 Cir. 1956); Cert. den., 352 U.S. 952; *Lloyd-Smith* v. *Commissioner of Internal Revenue*, 116 F.2d 642 (2 Cir. 1941).

Nor are we impressed with counsel's argument that the "other property" was not received by Turner within the meaning of the statute because the document was not formally authorized by action of the stockholders and directors as required by Virginia law, and, therefore, the corporation would have a defense to any suit brought thereon. It is sufficient to point out in answer to this argument that Turner was practically the sole stockholder and the President of the corporation, thus any assertion of these defenses by the corporation would be under his control. Looking to the substance of the transaction we think he did receive the property within the meaning of the statute.

Having accepted the court's finding of the value of the good will transferred to the corporation, there can be no question but that the so-called notice of indebtedness had a market value equivalent to its face. Even accepting the taxpayer's contention that no good will was transferred to the corporation, it still had tangible assets in excess of the face of the note, thus justifying the Tax Court's finding

that its market value was equal to its face since the holder of such an instrument had priority over the stockholders with respect to the corporate assets.

The second question raised by the taxpayer is whether the Tax Court was in error in finding that Turner received a cash bonus of $10,000.00 in 1957.

While the taxpayer is in the unfortunate position of trying to escape the consequences of his deliberate misrepresentations to the Virginia Corporation Commission we cannot but feel that the Tax Court ignored the obvious realities of the situation. The contemporaneous entries clearly reflected an intention that he have stock—there was no evidence of cancelled checks or cash transferal to support the court's findings. We are not to sit in judgment upon the taxpayer's moral standards. *J. M. Turner & Co.* v. *Commissioner of Internal Revenue*, 247 F.2d 370 (4 Cir. 1957). We find the Tax Court to be clearly in error on this issue. We must, therefore, remand the case in order that the court may determine the market value of the stock issued to Turner as a bonus and the tax year of its receipt.

Reversed in part and Remanded.

APPENDIX

JUDGMENT

Filed and Entered May 16, 1962.

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 8454.

Rufus F. and Marguerite H. Turner,
Petitioners,

vs.

Commissioner of Internal Revenue,
Respondent.

ON PETITION to Review the Decision of the Tax Court of the United States.

THIS CAUSE came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the decision of the said Tax Court of the United States, in this cause, be, and the same is hereby, affirmed in part and reversed in part as set forth in the opinion of the Court filed herein; and that this cause be, and the same is hereby, remanded to the Tax Court of the United States for further proceedings consistent with the opinion of this Court.

[Judges Omitted]

Filed May 16, 1962
R. M. F. Williams, Jr., Clerk

[caption Omitted]

The motion of the petitioners for a rehearing in this case has been read and considered, and the Court, being of the opinion that it was without merit, it is hereby denied. June 22, 1962.

[Judges Omitted]

June 29, 1962, mandate issued and transmitted to the Clerk of the Tax Court of the United States.

June 29, 1962, record of original papers and original exhibits returned to the Clerk of the Tax Court of the United States.

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In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 443

RUFUS F. TURNER AND MARGUERITE H. TURNER,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner R. F. Turner was engaged as a sole proprietor in the fresh produce wholesale grocery business. He caused a corporation to be organized to which were transferred on January 1, 1957, assets of the sole proprietorship, its good will and all of the liabilities of the business (Pet. App. 2–3). In exchange, petitioner received all the shares of the common stock of the new corporation (of which he was the president) and some time between January and November 1957 a "Notice of Indebtedness" which provided (Pet. App. 7–8):

664027—62

NOTICE OF INDEBTEDNESS

JANUARY 1, 1957.

For value received, We, Cash Produce Co., Inc., do hereby promise to pay to Mr. Rufus F. Turner, his heirs or assigns, the amount of Forty-eight thousand, eight hundred, ninety-three dollars and forty-six cents ($48,893.46) without interest, payable at the office of the corporation on or after February 1, 1958; also the corporation is not to furnish security of any type for this indebtedness. It is also agreed that the payee may draw funds from the corporation at any time upon the pledge of this note as security, said drawings to be deducted from the amount of this liability prior to settlement.

Accepted and agreed to the above this date January 1, 1957.

(S) RUFUS F. TURNER,
Payee.

Cash Produce Co., Inc.,
(S) RUFUS F. TURNER,
Registered Agent,
President.

Thereafter, in January 1958 the corporation issued to petitioner a long term debenture bond in the same amount in exchange for the Notice of Indebtedness. This transaction occurred a few day after petitioner had been advised by an accountant that the "Notice of Indebtedness" rendered the transfers to the corporation taxable rather than tax-free (Pet. App. 11).

Section 351(a) of the Internal Revenue Code of 1954 provides that "No gain or loss shall be recog-

nized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control * * * of the corporation." Section 351(b) in turn provides that where "other property" is receive in addition to stock or securities, the gain if any, to the recipient shall be recognized to the extent of the fair market value of the other property. The question presented here is whether both courts below properly sustained the Commissioner's determination that the Notice of Indebtedness was not a "security" but was "other property" within the meaning of Section 351 which was taxable to petitioner at its fair market value.

Petitioner contends that the Notice of Indebtedness was a "security" within the meaning of Section 351 (Pet. 10–17). He argues further that even if the Notice was properly found to be "other property" rather than such a security, it was but an intermediate step in a single preconceived plan looking toward issuance of the long term debenture and should, therefore, have been held tax-free (Pet. 18–19).[1] These contentions were properly rejected by both courts below. There is no conflict with the decisions of other courts, and the petition presents no question warranting review.

---

[1] Respondent has conceded that the long-term debenture issued in January 1958 is a "security" which, if issued under the circumstances outlined in Section 351, would be received tax free (Pet. 19).

There can be no question that the Notice of Indebtedness, which afforded petitioner an immediate right to "draw funds from the corporation * * * said drawings to be deducted from the amount of this liability prior to settlement," was not a security entitled to be received tax-free under Section 351(a). *Pinellas Ice Co. v. Commissioner,* 287 U.S. 462. Nor was the Notice an intermediate step in a preconceived plan looking toward issuance of such a security. The terms of the Notice were unconditional and gave petitioner an immediate right to withdraw from the corporation cash equivalent to its face value. At most, any plan was for petitioner to retain an option, exercisable at his will, to exchange the Notice for some other form of indebtedness.[2] The fact that he later chose to make the exchange—after receipt of further tax advice—does not render the issuance of the Notice a part of a preconceived plan and thereby avoid the tax consequences which attached upon its issuance.[3]

---

[2] The existence of any such plan, however, would have been in direct conflict with the express terms of the Notice of Indebtedness which provided that "the corporation is not to furnish security of any type for this indebtedness" (*supra*, p. 2).

[3] There is no merit to petitioner's alternative argument (Pet. 19–22, 24–25) that the Notice of Indebtedness had no fair market value. The contention rests on the claim, rejected by both courts below, that the good will transferred by petitioner to the corporation and shown on its books with value of $74,300, was actually valueless. As the court of appeals stated in affirming the Tax Court's finding that the good will had a fair market value equivalent to the value assigned to it on the books, "The contemporaneous conduct and declarations of [petitioners'] accountant as the man most familiar with taxpayers' business are certainly substantial evidence to support the court's findings" (Pet. App. 31–32). There is no cause for this Court to make a further review of this factual determination.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.
LOUIS F. OBERDORFER,
Assistant Attorney General,
ROBERT N. ANDERSON,
Attorney.

OCTOBER 1962.

U.S. GOVERNMENT PRINTING OFFICE: 1962

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REPLY TO RESPONDENT'S MEMORANDUM IN OPPOSITION

In The

SUPREME COURT OF THE UNITED STATES

October Term, 1962

No. **443**

RUFUS F. TURNER and
MARGUERITE H. TURNER
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

FORTESCUE W. HOPKINS
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In The

SUPREME COURT OF THE UNITED STATES

October Term, 1962

No.

RUFUS F. TURNER and
MARGUERITE H. TURNER
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY TO RESPONDENT'S MEMORANDUM IN OPPOSITION

The respondent has completely misstated the principal issue in this proceeding as evidenced by his statement (Mem.-3) that "Petitioner contends that the Notice of Indebtedness was a "security" within the meaning of Section 351 (Pet. 10-17)". The petitioner does not now (Pet. 10-17), and did not in his briefs filed in the courts below contend that the Notice of Indebtedness was a "security" nor does he contend that the long term debenture bond received on January 14, 1958 was a security (Pet. 19). In his petition, as amended (Appendix, infra), filed with the Tax

Court and in his briefs filed with the Tax Court and the Court of Appeals, the petitioners' contention, *inter alia*, has consistently been, as set forth and recognized in the respondent's brief (p. 18) filed with the Court of Appeals:

> "The taxpayer maintains that the 'Notice of Indebtedness' was substantially 'stock' and consequently no gain is to be recognized under Section 351(a). In this argument he contends that investment in the corporation represented by the 'Notice of Indebtedness' was essentially 'equity capital' like a stock interest".

It is obvious that the respondent is well aware of the nature of the issue here presented and the disposition that the Court of Appeals should have made as the respondent also stated in his brief before the Court of Appeals (p. 22, fn. 4):

> "In the event the Court of Appeals determines that the Tax Court should have made more specific findings on the equity v. debt issue, the case should, of course, be remanded with instructions. *Gilbert* v. *Commissioner*, 248 F. 2d 399 (C. A. 2d)."

Moreover, there is nothing in the argument (or cases relied upon therein) set forth in the Petition (10-17) that could possibly be construed to indicate that petitioners' contention was that the "Notice of Indebtedness", itself, was a "security" (and not "stock").

From the foregoing, it is reasonable to infer that the respondent has attempted to mislead this Court as to the nature of the issue here presented and, apparently, it has no valid objection or response to petitioners' argument that

the Notice of Indebtedness represents risk capital equivalent to "stock" (Pet. 10-17).

Since respondent's premise as to the issue here involved is in error, it follows that the case of *Pinellas Ice Co.* v. *Commissioner*, 287 U.S. 462, cited by respondent as authority for its position that the "notice" was not a "security" is not relevant to the issue here presented.
tions presented in the courts below is misleading and reflects an attempt to gloss over or ignore the precise questions raised in the courts below (Appendix, infra).

In denying that a taxable incorporation occurred, the following sub-questions were raised by the petition filed in the Tax Court and extensively argued in the courts below (see copy of amended petition, Appendix, *infra*):

1. The Notice of Indebtedness was an equity interest equivalent to stock (App. Par. 4 (f) (Pet. 10-17).

2. The Notice of Indebtedness was an intermediate step and not a concluding step in the incorporation of petitioner's business. (App. Par. 4 (a)) (Pet. 18-19).

3. The petitioners' business had: (a) no good will or (b) no *transferable* good will (App. Par. 4 (d)) (Pet. 19-22).

The respondent's allegation (Mem.-3)[1] as to the ques-

4. If the Notice of Indebtedness was "other property",

[1] "The question presented here is whether both courts below properly sustained the Commissioner's determination that the Notice of Indebtedness was not a 'security' but was 'other property' within the meaning of Section 351 which was taxable to petitioner at its fair market value."

it was not the "equivalent of cash" and therefore not "other property received" within the meaning of Section 351 (b) IRC 1954. (App. Par. 4 (c) & 4 (e)). (Pet. 22-24).

5. The Notice of Indebtedness had (a) no fair market value or (b) a value less than face value. (App. Par. 4 (c)) (Pet. 24-25).

A decision on any one of the foregoing questions in favor of the petitioner would eliminate the deficiency in tax and, contrary to respondent's allegation (Mem.-3), the decisions of other courts conflicting with the opinion of the courts below are (as set forth in the Petition) almost uncountable. The respondent's MEMORANDUM IN OPPOSITION is responsive to only two of the foregoing questions, i.e., "good will" and "step transaction".

GOOD WILL

In the respondent's memorandum (fn. 3, page 4), the respondent alleges that:

> "The contemporaneous conduct and declarations of (petitioners') accountant as the man most familiar with taxpayers' business are certainly substantial evidence to support the court's findings" (Pet. App. 31-32). There is no cause for this Court to make a further review of this factual determination."

As set forth in the Petition (pages 19-21) and on the basis of the *undisputed facts,* the decision of the courts below is clearly in error. Also, the question of the *transferability* of personal good will upon incorporation is a "legal" and not a "factual" question.

The Tax Court found that the Notice of Indebtedness was a concluding and not an intermediate step on the grounds that the notice was a (legally) "enforceable obligation" (Pet. App. 16-17) based upon its misconception of the applicable local law. It also found, contrary to all testimony adduced, that the execution of the long term debenture bond on January 14, 1958, was prompted by the advice of the petitioners' accountant's former supervisor that the Notice of Indebtedness would result in a taxable transaction (Pet. App. 11). In this connection, the statement at Page 2 of the memorandum that: "This transaction occurred a few days after petitioner had been advised by an accountant that the 'Notice of Indebtedness' rendered the transfers to the corporation taxable rather than tax-free (Pet. App. 11). "is not due any great weight for the reason that the accountant who gave the petitioner such advice was not the petitioners' accountant. The petitioners' accountant had considered the transaction to be tax free for the reason that he knew that the petitioner had intended the notice to be merely a temporary memorandum to be later supplanted by a more formal instrument of debt.

The Court of Appeals reviewed these facts in a somewhat different light and rejected the Tax Court's conclusion that the Notice of Indebtedness was an "enforceable obligation" since it was not formally authorized by the corporation (Pet. App. 32) and for reason of the rule of law in Virginia that "an officer cannot legally bind his company in a contract with himself without 'authority' expressly given." 13 Am. Jur. § 932; 4 Michie's Jurisprudence (Va., W. Va.) Corporations § 164.

The Court of Appeals did not completely reject the testi-

mony of the witnesses that a subsequent formal debt instrument was contemplated (Pet. App. 31). Rather, the Court of Appeals held that the issuance of the Notice of Indebtedness interrupted a preconceived plan "with unfortunate tax consequences to Mr. Turner." (Pet. App. 31)

In ignoring the test in step transactions (Pet. 18) which requires that the legal relations created by the first transaction not be fruitless, the Court of Appeals, apparently, relied upon the presumption that the petitioner, as sole stockholder, would not impose any legal defense to the payment of the notice. (Pet. App. 32). This presumption, however, is unwarranted. It has been held that where a corporation is newly formed the *presumption* is that the principal stockholder will not make withdrawals that would endanger the operation of the business or require its liquidation. *Brake & Electric Sales Corp.* v. *U.S.*, 287 F. 2d (C. A. 1, 1961); *Charter Wire, Inc.* v. *U.S.*,—F Supp—(DC Wis. Nov. 17, 1961). Also, the petitioner stated, at the time of incorporation, that he had no intention of paying the notice except out of the profits of the company (Pet. 6).

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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APPENDIX

[Caption Omitted]

MOTION FOR LEAVE TO AMEND PETITION

Come now the petitioners, by their attorney, Fortescue W. Hopkins, and respectfully move the Court for leave to amend their petition as follows.

Petitioners aver (and respondent has so advised petitioners' counsel) that the following amendments will not in any manner delay the hearing in this proceeding scheduled for the calendar of the Tax Court at Greensboro, North Carolina, beginning on September 26, 1960:

(1) The entire paragraph 4 of the Petition heretofore filed is eliminated and the following paragraph 4 is substituted therefor:

"4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in determining that the petitioners, in 1957, received a non-interest bearing note (notice of indebtedness) taxable as a long term capital gain in the amount of $48,893.46. In making this determination, the Commissioner erred in failing to determine that (1) the incorporation of Cash Produce Company, Inc. was a tax-free exchange under the provisions of Section 351, Internal Revenue Code 1954, and (2) the petitioners' receipt in 1958 of a long term debenture bond in the sum

of $48,893.46 was an integral step in the plan of incorporation of the said Cash Produce Company, Inc.

(b) Alternately, the Commissioner erred in determining that the said notice of indebtedness in the amount of $48,893.46 constitutes "other property received" within the meaning of Section 351(b)(1)(B), IRC 1954, and taxable to the petitioners in 1957.

(c) Alternately, if the Court should determine the said notice of indebtedness constitutes "other property received" within the meaning of Section 351(b)(1)(B), IRC 1954, the Commissioner erred in failing to determine that its fair market value was zero or substantially less than $48,893.46 and, therefore, no gain was recognizable to petitioners under the provisions of Section 351(b)(1), IRC 1954.

(d) Alternately, if the Court should determine that the said notice of indebtedness constituted "other property received" within the meaning of Section 351(b)(1)(B) and that it had fair market value, the Commissioner erred in determining that the total fair market value of assets received (notice of indebtedness plus 1,500 shares of stock) exceeded the cost of assets exchanged and that a gain was realized upon the exchange incident to the incorporation of petitioners' business.

(e) Alternately, if the Court should determine that the said notice of indebtedness constitutes "boot" taxable to the petitioners under the provisions of Section 351(b)(1)(B), the Commissioner erred in failing to determine that the said notice of indebtedness was intended merely as evidence of an obligation and not intended in payment thereof and, therefore, the Commissioner erred

in determining that the petitioners' realized taxable gain in the year 1957 evidenced by said notice of indebtedness.

(f) Alternately, the Commissioner erred in failing to determine that the said notice of indebtedness constituted an equity interest equivalent to stock or security and, therefore, erred in failing to determine that the incorporation was tax free under the provisions of Section 351, IRC 1954."

(2) Clause (h) is added to the end of paragraph 5 of the Petition heretofore filed:

"(h) The fair market value of the stock and other property, if any, received by the petitioners upon the incorporation in 1957 did not exceed the cost basis of the assets exchanged therefor ($49,593.46)."

WHEREFORE, it is prayed that this motion be granted and that the petition be amended as indicated above.

(Signed) FORTESCUE W. HOPKINS
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No objection.

(Signed) HART H. SPIEGEL
HART H. SPIEGEL

PJW

Chief Counsel
Internal Revenue Service
15 Sept. 1960

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OCTOBER TERM, 1962

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COMMISSIONER OF INTERNAL REVENUE

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PETITION FOR REHEARING

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PETITION FOR REHEARING

On November 28, 1962, the District Court's decision in *Charter Wire, Inc.* v. *U.S.*[1] was affirmed by the Court of Appeals for the Seventh Circuit[2] and is the basis for this Petition for Rehearing. The criteria adopted by the Dis-

[1] —F. Supp.— (DC Wis. Nov. 17, 1961) (8 AFTR2d 5993).

[2] —F2d — (C.A. 7, Nov. 28, 1962) (10 AFTR2d 6030).

trict Court and the Seventh Circuit in holding that an obligation created upon incorporation was the equivalent of stock (risk-capital-equity) results in a rationale and a decision diametrically in conflict with the Tax Court's arbitrary conclusion here (as affirmed by the Fourth Circuit) that the notice of indebtedness was not the equivalent of stock. We have been advised by counsel for *Charter Wire, Inc.*, that a petition for writ of certiorari will be filed. Accordingly, if certiorari is granted in this case and in *Charter Wire, Inc.*, we respectfully suggest that the two cases be heard together. Also, the Commissioner may seek certiorari in the recent case of *Nassau Lens Co.* v. *Comm.*[3]

Rule 19(1)(b) of the Supreme Court's Rules sets forth the primary bases for consideration of whether a writ of certiorari shall issue. Observing the precepts of this rule as it applies to the sole issue[4] here of whether the notice of indebtedness received by the petitioners upon incorporation was "debt" or "equity", it is evident:

(1) The Tax Court's decision here, as affirmed by the Fourth Circuit, is directly in conflict with the following additional Court of Appeal decisions:

(a) *P. M. Finance Corp.* v. *Comm.*, 302 F2d 786, (C.A. 3, May 10, 1962 (9 AFTR2d 1454)

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[3]—F2d — (C.A. 2, Sept. 17, 1962) (10 AFTR2d 5581) See commentary of Research Institute of America, Vol. 2, Recent Developments, Par. K-5108 for an excellent summary of this question and their reasons for anticipating Supreme Court review of this question.

[4] Rule 58(2) restricts the Petition to the ground above specified (Pet. Argument "A").

(b) *Brake & Electric Sales Corp.* v. *U.S.*, 287 F2d 426 (C.A. 1, 1961) (7 AFTR2d 921)

(c) *O. H. Kruse Grain & Milling Co.* v. *Comm.*, 279 F2d 123, 125-126 (C.A. 9, 1960) (5 AFTR2d 1544)

(2) By reason of the many incorporations that involve the creation of evidences of debt, the Court of Appeals for the Fourth Circuit has decided an important question of federal law which has not been but should be settled by this Court. For the Commissioner to here contend that the notice of indebtedness was debt constitutes a most appalling degree of hypocrisy.[5] Denial of certiorari here will give the Commissioner "carte blanche" to continue his conflicting determinations of what constitutes "debt" or "equity" upon incorporation.

(3) The Court of Appeals for the Fourth Circuit has sanctioned the Tax Court's determination that the obligation created upon incorporation was "debt" on the basis of the sole characteristic that the notice of indebtedness was a "note" in direct conflict with this Court's decision in *John Kelley Company & Talbot Mills* v. *Comm.*[6] which provides that "*** There is no one characteristic, *** which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts. ***".

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[5] In the cases referred to in paragraph (1) above, it was the Commissioner's contention that the debt ~~credited~~ created upon incorporation was the equivalent of stock.

[6] 326 U.S. 521, 66 S. Ct. 299, 304

(4) If failing to remand the Tax Courts decision for a better statement of the basis of its conclusion that the notice of indebtedness represented debt (and not equity) as suggested by the respondent! and for failing to so much as even acknowledge the existence of this extensively presented issue, the opinion of the Fourth Circuit "*** has so far departed from the accepted and usual course of judicial proceedings, or has so far sanctioned a departure by a lower court, as to call for an exercise of this court's power of supervision".

The Tax Courts decision here (Pet. App. 24):

> "It is unnecessary to discuss petitioner's final contention that the notice of indebtedness represented an equity interest equivalent to stock, *in view of our holding that the notice of indebtedness is a note*" (emphasis supplied).

for all that appears, indicates that its determination was based on the single reason that it found the notice of indebtedness to be a "note". Even where the standard of law is not complex, as it certainly is here,[7] this Court has held that such an unelaborated finding of ultimate fact cannot stand as fulfilling the requirements of Rule 52, Federal Rules of Civil Procedure, 28 U.S. C.A., in that "It affords the reviewing court not the semblance of an indication of

[7] The Kruse case, supra, refers to ten separate criteria (or standards) in addition to the form of the debt to test whether "debt" or "equity" exists.

the legal standard with which the trier of fact has approached his task". *Stanton* v. *U.S. sub. nom. Comm.* v. *Duberstein*, 363 U.S. 278, 80 S.Ct. 1190. Moreover, it has been held that under the provisions of § 7459(b) of the Internal Revenue Code of 1954 (68 A Stat. 886) "*** the Tax Court is required to do more than pronounce a conclusion since it must lay bare for judicial review—as well as for the parties—the basis of its decision. *Wisconsin Memorial Park Co.* v. *Comm.*, 255 F.2d 751 (C.A. 7, 1958) (1 AFTR2d 1726)

CONCLUSION

If this Court believes that certiorari should not here be granted for the purpose of considering the merits of the single question of "whether the notice of indebtedness constitutes debt or equity," then it is respectfully urged that this Court remand this specific question to the Tax Court for further proceedings "to lay bare for judicial review—as well as for the parties—the basis of its decision on this question" or grant such other, further relief, as in the premises, it may deem fit and proper.

Respectfully submitted,

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CERTIFICATE OF COUNSEL

Pursuant to the requirements of Rule 58 (2) of this Court, the undersigned counsel certify that this Petition for Rehearing is being made in good faith and not for any purposes of delay and that the Petition is restricted to the ground above specified.

Fortescue W. Hopkins
H. Clyde Pearson